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SUBJECT: South Africa: Minerals and Energy Newsletter "THE ASSAY" - Issue 12-1, December-January, 2008

This cable is not for Internet distribution.

¶1. (SBU) Introduction: The purpose of this newsletter, initiated in January 2004, is to highlight minerals and energy developments in South Africa. This includes trade and investment as well as supply. South Africa hosts world-class deposits of gold, diamonds, platinum group metals, chromium, zinc, titanium, vanadium, iron, manganese, antimony, vermiculite, zircon, alumino-silicates, fluorspar and phosphate rock, and is a major exporter of steam coal. South Africa is also a leading producer and exporter of ferroalloys of chromium, vanadium, and manganese. The information contained in the newsletters is based on public sources and does not reflect the views of the United States Government. End introduction.

HOT NEWS

Energy Crisis Developments

¶2. (SBU) As of January 31, most South African mines and plants are back in production, but Chamber of Mines Technical Advisor Dick Kruger has told the Embassy that mines are receiving only 80 percent of power needs. This is less than the 90 percent promised by Eskom and is, according to Dick, likely to stay at this level for some time. This means that mines may have to implement staggered operations with the concomitant slowing of production. Major mines and plants in South Africa have been at a standstill since January 25 when Eskom could no longer guarantee sufficient power to operate and ensure workers health and safety. Estimated production losses for the gold and platinum mines alone exceed $40 million per day.

¶3. (SBU) In the interests of safety, Eskom agreed to provide sufficient power to allow maintenance crews underground to ensure safe conditions when the mines re-opened. As power supply stabilizes and mines ramp up to full production, they have agreed to cut back on power demand by 10 percent. AngloGold's Mponeng mine voluntarily reduced power consumption by 30 percent in advance of the crisis, according to the mine's General Manager. However, as Hernic Ferro-chrome Operations Director Jasper Pieters put it, 10

percent less electricity means 10 percent less production.

¶4. (SBU) Coal supply to Eskom has also been severely compromised by the weather and stocks are at an all-time low. Major coal suppliers are working at full throttle and have agreed to provide an additional 5 million tons per month for the next three months to build up stocks. The weather has also caused production problems for open pit mines and material handling systems. The Minister of Public Enterprises has indicated that if the coal supply situation does not rapidly improve, the SAG may impose emergency measures to divert some export coal to power stations. The impact of mine closures on small mines and coal suppliers is not known, but could be severe.

GOLD

SA Still on Top but for how Long?

¶5. (SBU) South Africa has been the world's biggest producer of gold since 1905, reaching a peak output of 1,000 tons in 1970. According
Qsince 1905, reaching a peak output of 1,000 tons in 1970. According
to London-based Gold Fields Mineral Services (GFMS), South Africa has produced 52,000 tons of gold from the Witwatersrand basin in the past 122 years, which accounts for 32 percent of all gold mined in the world to date. Since then, output has steadily declined to the current estimated production for 2007 of 272 tons, as mines became deeper, operating costs increased, and gold price and the rand/dollar exchange rates showed extreme volatility.

¶6. (SBU) At the same time, Chinese production increased, reaching an estimated 270.5 tons for 2007. This ranks China as the number two producer, just short of South Africa's output. South Africa could

add over one million extra ounces (32 tons) to annual output as planned production from new mines and expansion projects kick in over the next three to five years, provided that safety and electricity disruptions are contained and the gold price continues its upward march towards $1,000 per ounce, as is forecast by a number of analysts and (of course) mining companies.

OIL and GAS

Oil Exploration Impasse Deja Vu?

¶7. (SBU) Exploration off South Africa's west and south coasts has, to date, come up with only a few small producing oil and gas fields in relatively shallow water. However, seismic surveys of deeper areas indicate potentially favorable oil structures. BHP-Billiton, the world's largest mining group, holds rights to two deep water leases off the west coast, which it has attempted to bring to account for years, but it continues to bump heads with the government over the conversion of its exploration leases to new order mining rights, as required by the Minerals Act of 2002.

¶8. (SBU) A key obstacle is understood to relate to the Department of Minerals and Energy's (DME) insistence that local courts arbitrate in disputes while BHP wants the International Court of Arbitration to resolve commercial disputes - consistent with many oil-producing countries. The government has also blocked stabilization provisions that would protect BHP from any future changes in the law. BHP's old-order sub-leases are believed to include access to international arbitration and "stability clauses" and the government appears to be using the conversion requirement to remove these rights.

¶9. (SBU) The BHP/DME dispute over rights dates back to 2005 when, in partnership with Occidental Oil (U.S.), BHP planned to begin drilling a deep well at a cost of about $50 million. The drilling program would have given South Africa its first deep-water oil

exploration well, but was postponed because of a number of uncertainties in the new mining legislation. These concern issues related to production-sharing, conversion of mineral rights, taxes and royalties, and the decision-making power given to the Minister of Minerals and Energy. This followed a decision in November 2005 by the board of the oil and gas licensing authority (Petroleum Agency of SA known as PASA) to reject an application for a permit for two lease blocks off the country's east coast by Global Offshore Oil Exploration (a U.S. company) on the grounds that it was "not happy about the applications process" - Global was one of BHP's partners in the deep-water venture. The postponement has delayed the drilling for two years and may delay it again unless the impasse with the DME is resolved, and provided a drilling rig is available.

DIAMONDS

De Beers Retains Rights to Dumps

¶10. (SBU) More than 130 years of diamond mining has created huge waste dumps of discarded material around mining areas. Early
Qwaste dumps of discarded material around mining areas. Early
recovery processes were inefficient and large quantities of diamonds landed on the dumps. The majority of stones are in the smaller categories but larger stones have been recovered from dump re-treatment operations. It is now recognized that these dumps constitute a valuable resource of diamonds and they are being processed together with mined kimberlite or as a stand-alone operation. Many have been acquired by small black empowerment companies. It has always been assumed that the dumps belonged to the mine operators and represented an integral part of the mining right. However, this right was challenged when the Department of Minerals and Energy (DME) granted a prospecting right to Ataqua Mining for dumps at De Beers' Jagersfontein mine in the Free State Province, where mining operations ceased in 1971. De Beers

immediately took the case to court.

¶11. (SBU) The High Court ruled in favor of De Beers and set aside the granting of that right by the DME, stating that South Africa's new mining legislation did not apply to the treatment of old tailings dumps. The judgment has far-reaching implications in that it means mining companies recovering minerals such as gold, diamonds and platinum from tailings dumps do not have to apply for a mining right in terms of the Minerals and Petroleum Resources Development Act (MPRDA), which came into effect from 2004. This, in turn, means the tenets of the Mining Charter and social and labor plans do not apply to dump recovery operations. A specialist on mining issues says that the significance of this judgment is huge and means that every dump in South Africa can be mined without having to apply for a mining right if ownership can be proved.

ELECTRICITY

Pouring Water on the Energy Crisis

¶12. (SBU) The very wet rainy season that South Africa is "enjoying" has poured cold water on power utility Eskom's attempts to maintain a semblance of reliability to its power supply. With a 3 percent to 8 percent nominal reserve capacity and demand frequently exceeding supply (due to planned and unplanned maintenance), scheduled and (mainly) unscheduled outages have occurred daily and now the heavy rains have added another dimension to Eskom's (and the country's) woes. Open cast coal mines have reduced output because of flooding, coal handling from mine mouth to power station by either road or conveyor belt has been impeded, coal stockpiles at plants have been flooded, and wet coal has caused feeding and efficiency problems in the boilers. Added to this is the fact that the price of export

coal is fetching well over $100 per ton (some seven times the domestic price), and more of the higher quality coal is being diverted to this market, leaving Eskom with an even lower quality of coal than it is used to. As a result, power station stocks are down to four days supply and one mega-station is feeding directly from mine delivery.

¶13. (SBU) Two years ago, an electricity outage (blackout) was an extremely rare event in South Africa. Then, in December 2006 one of the two generating units at Koeberg (900 megawatt capacity each), the country's only nuclear power station, was severely damaged when a loose bolt got into the rotor. This set off a series of blackouts, mainly in the Western Cape, which lasted until a new rotor was installed in about May-June of 2007.

¶14. (SBU) From then on, outages became increasingly frequent until, with the advent of summer (September), they have become an almost daily occurrence culminating on January 25 with the closure of most mining operations throughout the country because Eskom could not guarantee supply. This is likely to cost the mines and the country billions of rand in lost revenues and foreign exchange and in potential investment in energy-intensive ventures. The SAG has
Qpotential investment in energy-intensive ventures. The SAG has declared the power outages a national emergency that must be treated with urgent actions, including a hike in electricity prices and mandatory quotas with penalty and incentive systems. The next week will tell whether the situation has improved.

¶15. (SBU) Comment. The energy crisis has resulted in the inevitable apportioning of blame and making of excuses by major players in the industry. These include policy interventions by government, poor planning and management by Eskom, the mining industry's failure to produce sufficient coal, transport contractor's inability to deliver coal to the power stations, and the high rainfall over the early summer months. However, the primary causes of the crisis are: government's failure to do anything when it was clear as early as 1997/8 that a power shortage was pending; at the same time state-owned utility Eskom was forbidden from building new capacity as government wanted the private sector to do this; government continued to procrastinate until 2004 when it was obvious that the

private sector was not coming to the party; failure of heavy users of power to make adequate provision to protect themselves against power shortages; and government and Eskom's black empowerment policies (transformation) which saw skilled and experienced employees and contractors replaced by inexperienced people. End Comment.

First Greenfield IPP to be Online in 2010

¶16. (SBU) South Africa's energy and skills crises have inspired the SAG to offer 30 percent of planned new energy projects to the private sector (IPPs or independent power producers) in an attempt to speed up the building of new generation capacity. The AES-Khanya consortium has been designated as preferred bidder to build two 500 megawatt open-cycle gas-turbine (OCGT) power stations (probably fueled by diesel to start with). Start of construction has been delayed, but the Department of Minerals and Energy's (DME) Chief Director for Electricity said that the stations could still come on line by the end of 2009. The two power plants will together add 1,000 megawatts to the national grid and will be located in KwaZulu-Natal and Coega (site of Rio Tinto's proposed 725,000 ton aluminum plant) in the Eastern Cape. DME estimated the cost of the two plants at $750 million, of which $120 million would be foreign direct investment. The AES-Khanya project represents the first IPP involved in a significant greenfield project. The consortium is led by U.S.-based AES and incorporates three local black economic empowerment partners.

Gas Turbines the Way to Go in a Crisis

¶17. (SBU) The Managing Director of Eskom's Enterprises Division said that gas turbines are the only way to beat power cuts faster. If this option were not taken, frequent power cuts would continue for many years until new base load plants were completed from 2015. He said that a gas turbine plant was quick to build and had a relatively low capital cost but that fuel would be expensive and would require millions of liters of diesel. State power supplier Eskom has already completed two 500-megawatt peak-demand gas turbines on the west and south coast, respectively. These plants were completed in 18 months and designed for a load factor of 6 percent but were now running at 50 percent to meet regular demand. A further two turbine plants with a combined 1,000 megawatts are being built, but would only be completed next year after Eskom had to wait six months for the decision on the environmental impact study. Eskom is considering converting these plants to closed cycle, which would make them more fuel efficient and produce more power.

Power Hike of 14.2 percent for 2008

¶18. (SBU) South Africa produces the lowest cost electricity in the world and has used this advantage to attract heavy energy users, such as metal smelters, refiners and fabricators, to set up shop in
Qsuch as metal smelters, refiners and fabricators, to set up shop in
the country. The developing energy generation shortfall has resulted in scheduled and unscheduled electricity cuts that have already caused production losses to large and small businesses amounting to hundreds of millions of dollars. Eskom has budgeted some $50 billion over the next five years and expects to spend $150 billion by 2025 to double its generating capacity to 80 gigawatts.

¶19. (SBU) Financing is likely to come from local and international money markets, from the SAG as owner, and from Eskom's own cash flows. Eskom maintained that the current tariffs were significantly less than the 5.5 US cents it would cost to build 1 kilowatt-hour (kWh) of new capacity and that its cash flow was insufficient to fund the expansions. It approached the National Energy Regulator (NERSA) for approval to hike rates by 18.7 percent in 2008, 17 percent in 2009 and 11 percent in 2010. The Regulator agreed to allow Eskom to increase tariffs to customers, excluding

municipalities, but by 14.2 percent (up to 3.5 US cents per kilowatt-hour) in 2008. The 184 municipalities that distribute electricity are also set to raise tariffs by 12 percent from mid-2008.

¶20. (SBU) Business has not taken the increases lightly and states that these are likely to worsen the already high inflation rate of 8.6 percent. They believe that more creative ways can be found to finance Eskom's needs that do not rely so heavily on tariff rises. The Technical Advisor to the Chamber of Mines said the hike would cause increases in working costs of at least 1.4 percent at gold mines, more than 1.4 percent at platinum mines, and 1.1 percent at collieries. However, he said that the mining industry was not surprised at the hike, especially due to the increase in the cost of coal. NERSA calculated that the hike would add 0.5 percent to annual inflation. While they took note of concerns that the hike would hurt the economy, particularly the poor, they believe that the long-term benefits far outweighed the short-term fears and that there had to be a trade-off between industry sustainability and other socioeconomic goals. NERSA's Chief Executive said the increase would encourage more independent power producers to enter the local market.

MINING

Mining Boosts South Africa's Export Revenues

¶21. (SBU) Record prices have been received for nearly all the commodities produced by South African mines during 2007 and these have carried over into 2008. Critical commodities breached key psychological barriers and revenues for platinum, rhodium, palladium and gold are expected to earn $26 billion in 2008 compared with $16 billion in 2006. In the year to February 2007, the mining sector tax revenue exceeded the original estimate by nearly $4 billion. The Chief Economist of the Efficiency Group pointed out that traditionally 1 percent of state revenue came from the mining sector, but this is likely to increase to 3 percent in 2007.

¶22. (SBU) Given adequate power and a continuation of the global commodities boom, South Africa's mining industry seems set to increase its foreign exchange earnings from both current operations and a number of new mining projects due to start or reach full production over the next few years. The major supply expansion projects are in the hands of the private sector while the concomitant infrastructure expansions are state-owned and subject to government and environmental approvals, all of which tend to delay projects and increase costs.

¶23. (SBU) Most of South Africa's mineral exports have experienced dramatic price increases. Export steam coal hit $100 per ton in November and has since touched $130 per ton on the spot market. This is seven times the price paid for domestic coal, admittedly of inferior quality for power generation. Gold crossed $900 per ounce and is forecast to hit $1,000 per ounce in early 2008. Of the PGMs, platinum breached $1,700 per ounce, rhodium $7,000 per ounce and the
Qplatinum breached $1,700 per ounce, rhodium $7,000 per ounce and the
demand and prices for palladium and ruthenium increased substantially.

¶24. (SBU) Uranium prices increased by a factor of ten to some $200 per pound in mid 2007 but have since come back to about $60, which is still well above the $20 per pound of a few years ago. Prices for iron ore and steel and for base metals such as copper, nickel, cobalt, lead, and zinc have doubled and tripled over the past two years and other commodities are at or near record levels. Chinese demand continues to be the driving factor, while worries about the United States economy and the environment raise uncertainty, which is good for gold and platinum. South African mining companies have benefited from higher commodity prices but are struggling to control higher costs and increase production.

BOST